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BEFORE THE
Federal Communications Commission
WASHINGTON, D.C.

DEC 10 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matter of)

Amendment of Parts 32 and 64 of)
the Commission's Rules to Account)
Transactions between Carriers and)
Their Nonregulated Affiliates)

CC Docket No. 93-251

COMMENTS OF THE
INTERNATIONAL COMMUNICATIONS ASSOCIATION

Brian R. Moir, Esquire
1255 23rd Street, N.W.
Suite 800
Washington, DC 20037-1170
202/331-9852

Its Attorney

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INTRODUCTION

The International Communications Association (ICA) hereby submits its initial comments concerning the Notice of Proposed Rulemaking, released October 20, 1993, (FCC 93-453). ICA supports most of the proposals in the Notice and urges the Commission to reinforce these proposals and the factual bases for their tentative conclusions.

ICA INTERESTS

ICA is the largest association of telecommunications users in the United States. Recent estimates indicate that ICA members spend approximately \$21 billion per year on telecommunications services and equipment. The bylaws of the ICA exclude any firm that is predominantly engaged in the production, sale or rental of communications services or equipment from eligibility for membership. ICA members are large users of each and every type

of existing or potential service offered by the carriers subject to the Commission's cost allocation rules, including many nonregulated services and activities.

ICA has no interest in seeing that regulated carriers are precluded from offering new, potentially valuable, nonregulated services. However, ICA is concerned that the joint cost rules (as adopted) contain too many loopholes, or avenues for the evasion of normal, customary business practices, and believes that fair competition in the provision of any such services should be a fundamental mandate of the Commission.

Virtually all multi-product businesses engage in allocations of joint costs associated with multiple activities, including most ICA's members.^{1/} For those businesses subject to rigorous competition in all of their product lines, both marketplace forces and internal corporate dynamics serve to enforce the type of cost allocation discipline that the Commission's policies envisage.

Firms subject to pervasive competition have natural incentives to ensure that their products cover all of their costs and contribute to the overheads and profits of the firms as a whole. They use internal line of business reporting to demonstrate that these objectives are in fact satisfied. The managers of one profit center have similar incentives to see to

^{1/} Two-thirds of ICA member companies employ over 10,000 persons; only 2% have work forces under 1,000 and over 86% of these firms conduct business from fifteen or more locations. The size and extent of these activities means that ICA members regularly engage in cost allocations.

it that none of their colleagues managing other businesses gain a "free ride" with respect to cost allocations. No one competitive business segment is allowed to exist, over time, in a way that over-allocates costs to another business segment, and thus misrepresents the financial performance of both sectors. As the Commission has long recognized, firms like local exchange carriers (LECs) whose major revenue streams are virtually exempt from competition, do not possess these same incentives.

While this principle cannot be argued, the policies by which the Commission attempts to change the natural incentives of the LECs--and the entire concept of "nonstructural safeguards"--has not been fully or appropriately implemented. ICA regards the reforms proposed in the Notice, while long overdue, as absolutely necessary to create the conditions under which telecommunications competition can develop.

THE NOTICE

The Commission proposes a number of critical reforms to the current joint cost allocation rules. The rules for valuation and transfer pricing would be extended to more uniformly cover asset and service transfers among entities. The subjective use of "prevailing company prices" as a valuation "test" would be significantly curtailed in favor of more objective measures of valuation. The Notice proposes to limit prevailing company prices as a valuation method to circumstances where nonregulated

entity sell at least 75% of the output to non-affiliates.^{2/} The book cost versus fair market value "ratchet" applied to asset transfers, into or out of regulation, would be extended to service transfers.^{3/} Auditing and reporting requirements affecting affiliate transactions would be clarified and, to some extent, strengthened.

The Notice also proposes to simplify and streamline the process by which the full costs of affiliate transfers would ordinarily be calculated. The Commission generally proposes to adopt the same costing rules that pertain to the LECs' regulated interstate services. This approach will make it easier for carrier personnel, Commission staff and outside auditors to evaluate each LEC costing method for affiliate transfers, because these rules will parallel the process for interstate services.^{4/}

ICA believes that this is a good approach administratively, and that it will not impair any carrier's selection or offering of non-regulated services. The cost allocation rules for such non-regulated activities do not, of course, dictate how a carrier will price or otherwise make available a non-regulated service. These decisions are presumably driven by the competitive market for such services. Using the same costing process that is applicable to regulated interstate services will, however, better insulate these services from cross-subsidies. The carrier will

2/ Notice, paragraphs 15-22.

3/ Notice, paragraphs 30-34.

4/ See Notice, paragraphs 41-42, et seq.

have a better overall picture of the financial performance of its non-regulated services. The only effect of developing uniform costing rules is to ease the administration of the program and ensure that shareholders, not ratepayers, are affected by the carrier's business decisions. The LEC will remain free to carry any losses associated with the service until its market develops, or to discontinue a non-viable offering, to reprice it or re-position it in the market, or to engage in any business decision that a fully competitive business would confront in similar circumstances.

We recommend adoption of a few of the less restrictive options proposed in the Notice, and then do so only where such an option may be appropriate to limit the administrative burdens on the Commission staff.

THE UNDERPINNINGS OF THE NOTICE

ICA recommends that the Commission provide more details and citations to support its conclusions that the current affiliate transaction rules need to be greatly strengthened. The Commission should also underscore its determination that the proposed rule changes complement other policies like price caps, in order to counter the inevitable assertions by some carriers that price caps alone are sufficient to prevent the cost-shifting incentives identified in the Notice.

Many parts of the Notice refer generally to findings and conclusions that the Commission has reached over time regarding carrier practices with respect to affiliate transactions and to various exception treatments, carrier assertions and other conditions that staff have encountered.^{5/} These events are clearly the product of several years of experience with individual carrier's manuals, practices and staff audits. But because the Notice refers to few specific examples, the general public, legislators and, most importantly, a reviewing court might not understand the factual bases that more than fully support the Commission's proposals. These facts should be elaborated in more detail if the Commission adopts any part of these proposals.

A great deal of the Commission activity concerning the cost allocation manuals has occurred outside the public eye. Major FCC audit determinations, such as those involving NYNEX Matriel Enterprises in 1990, or the recent findings involving transfers between Bellsouth Services and its affiliated operating telephone companies, have been based upon data that is not disclosed to the public. The carrier's cost allocation manuals have been obtuse, non-uniform and difficult to compare.^{6/} Understanding the

^{5/} See Notice, at paras 9-11, 24, 28, 32, 39, 48-49, 107-108.

^{6/} The Commission recently required the cost allocation manuals to be amended so as to provide greater uniformity, noting that "Through our audit and review process we have found that... additional uniformity in the CAMs is necessary in order for us to provide more effective oversight" Implementation of Further Cost (continued...)

carriers' exact accounting practices requires access to supporting records and procedural documents that are not submitted for public review. Most audit work papers developed by the FCC staff or outside auditors remain secret. Thus, ICA believes that the Commission should specify with greater particularity the bases for its conclusions. This does not require that heretofore undisclosed data be placed before the public, although ICA believes that additional disclosure would be healthy and lead to better-informed policy making at all levels of government.

Likewise, ICA believes that the Commission should highlight the time-frames in which it developed the findings discussed in the Notice. It is important that the record in this proceeding reflect that the Commission's current concerns began when it adopted price caps for LECs in 1990. The Commission should make it clear that its conclusion "far from supporting the present valuation method for services...efficiency incentives provide a basis for abandoning that methodology",^{7/} is derived from experiences both before and after the LEC price caps plan was adopted. Fundamentally, price caps, even if they were fully

6/(...continued)
Allocation Uniformity, Memorandum Opinion and Order, AAD 92-42 (DA 93-768), July 1, 1993, at para. 6. The Commission indicated that further revisions of this nature may be prescribed in the manuals. Id. para. 41.

7/ Notice, para. 32.

effective,^{8/} could not provide a viable substitute for uniform competitive market cost allocation principles.

The problem rests in the enormity of the regulated sector and the relatively small size of newer LEC ventures into non-regulated activities. Very adverse effects on competition among non-regulated services and on the overall viability of the FCC's approach to nonstructural safeguards can occur with even relatively small amounts of improper cost shifting. If a carrier with \$2.85-billion in annual interstate revenues (the RBOC average for 1991) improperly absorbed 50% of the \$50-million start-up costs of a nonregulated venture, competition facing the same start-up costs could be entirely forestalled, even though the relative immediate impact on regulated interstate rate levels would be less than 0.9%.^{9/} The adverse effects on ratepayers are the cumulative impacts of non-economic transfers under price caps. Not only would competitive choices be limited but, over time, the cumulative burden of the cross subsidies on regulated services would mount. Additionally, the lower formula adjustment under price caps could come into play if the cross subsidy adversely affected the carrier's earnings from regulated interstate services.

8/ ICA believes that the current Price Caps regime is far from being adequately effective, as documented in ICA's June 11, 1993 comments regarding the Petition to Establish a New Regulatory Model for the Ameritech Region, DA 93-481.

9/ If these subsidies were also borne by intrastate services, the immediate impact on regulated services would be even smaller.

The Commission is correct to conclude that the best use of uniform competitive market principles is not only to limit tariff prices through an effective regulatory regime, but also to create affiliate transfer incentives that mimic as much as possible, a market in which all products and services are equally subject to full competition. The Commission would be correct in discounting carrier arguments to the contrary. ICA agrees with the Commission and looks forward to closely reviewing the comments submitted by proponents of the present system in response to the Commission's invitation at paragraph 33 of the Notice. Furthermore, it is fully consistent with the Commission's determinations that any savings to ratepayers that may be realized as subjective and arbitrary allocations is properly exogenous to price caps and should be so treated.^{10/}

OTHER ISSUES

As noted above, ICA concurs with most of the details concerning how the affiliate transfer cost allocation reforms would be implemented and interpreted. In a few areas, however, some additional comments are warranted.

The Pricing and Costing Hierarchy

The Notice generally proposes to maintain the primary preference afforded affiliate transfers that occur pursuant to tariff rates.^{11/} This is appropriate. However, the Commission

^{10/} Notice, paragraph 36.

^{11/} Paragraph 8, et seq.

should take account of changes that will occur in LEC tariffs in the future. In the Expanded Interconnection proceeding [CC Docket No. 91-141] and other proceedings, the LECs are being afforded greater opportunities for price discrimination in response to possible emerging competition. This discrimination takes the form of zone density pricing and other types of de-averaging. These changes in pricing rules may undermine, to some extent, the concept that reference to a carrier's (single) tariffed price assures that an affiliated transaction at that price will be fair and non-discriminatory. In the future, transactions with affiliates and unaffiliated third parties may occur by means of more customized pricing plans, in which preferences for the unregulated affiliate of the carrier are more difficult to detect.

Therefore, while the tariffed rate test remains the most workable practical approach at this time, enforcement of this approach would be aided if the Commission required each carrier to list in its CAM each section and subsection of a tariff on file that governs its transfers of services under this section, particularly if the tariff pricing involves a "custom deal".

Where tariff rates are not used to value an affiliate transaction, ICA supports the Commission's proposals that costing principles used for affiliate transactions should generally mirror practices applicable to regulated interstate services, as we noted above. The Notice contains an extensive discussion of how these principles would be applied with respect to costing for

affiliate transactions.^{12/} Undoubtedly, the dominant carriers who will be subject to these requirements will suggest that they are burdensome or unnecessary.

The Commission should consider allowing carriers to use somewhat more "streamlined" approaches to costing affiliate transactions, than the detailed item-by-item approaches discussed in the Notice, but should allow such approaches only when they are applied uniformly across most cost-based valuations of affiliate transactions and regulated service filings. A somewhat more streamlined approach would enable a carrier to specify general overhead, depreciation, and other loading factors to be applied to the direct costs of the assets or services involved in the transfer. Then the valuation of the transfer and the auditing of that process would be simplified, with only a slight tradeoff in the level of cost allocation accuracy that would be achieved under item-by-item cost analyses.

The streamlined approach should be allowed at the carrier's option if, and only if, one important condition is first satisfied: The same common factors would have to be applied in each and every regulated service cost filing that the carrier makes, including any filing under the "new services" tests under price caps. Currently, the Commission's ability to review and approve tariff filings is impaired by some carriers' selective use of many different overhead factors and other loadings in

^{12/} Notice, paragraphs 54-76.

different tariff filings.^{13/} Carriers may be able to identify all of the service-specific costs of an offering they wish to price at premium levels, and then apply general overhead factors or other loadings. It is almost impossible, given Commission resources, to determine if, where and how much "double-counting" occurs through such costing techniques. Consequently, the Commission's ability to completely and promptly review important tariff filings is now quite limited.

Any "streamlining" that carriers are permitted with respect to the costing rules discussed in the instant Notice should apply in the same way to the regulated service tariffs.

Valuation for Purposes of Applying the 75% Test

ICA agrees with the Commission's proposal in paragraph 85 of the Notice that carriers should use their current valuation methods for purposes of satisfying the 75% test for the current period before the revised valuation rules are effective. Using a carrier's current method is appropriate in order to provide a baseline against which the Commission can test the effects of the new valuation rules. If a carrier has been understating the value of affiliated transfers, it is less likely to satisfy the 75% test. The reduced reliance upon prevailing company pricing that follows from failure to satisfy the test is a correct starting point for the new rules. Carriers should be able to revise their valuations, and perhaps satisfy the 75% rule with

^{13/} See Local Exchange Carriers Rates, Terms and Conditions for Expanded Interconnection for Special Access, First Report and Order, CC Docket 93-162, Phase I, November 12, 1993 [FCC 93-93].

respect to a greater number of transactions, only after the rules have gone in effect and the appropriate revisions to the CAMs have been approved by the Commission.

The Commission also requests comments about the valuation basis for the 75% rule.^{14/} ICA believes that the product line or line of business definitions will be difficult to apply in practice if such definitions cover every activity affirmatively. Instead, the Commission should adopt the total company approach but require carriers to identify, on an exception basis, activities which should be excluded in determining whether the 75% test is met. Exclusions from the total company calculation should occur for product lines or lines of business that (a) provide unique or separately identifiable services, and (b) have less than 50% volume of business with unaffiliated entities.

Under this "exception" formulation, more transactions may qualify for the prevailing company price valuation standard because the aggregated values of the total company approach are more likely to reach 75% on average. However, the approach will be easier to administer and audit than the alternatives requiring analysis and definition of each product or line of business. The Commission, however, should ensure that carriers do not utilize the total company approach to circumvent the proposed limits on utilization of "prevailing company prices". The Commission should strictly require that carriers identify each affiliated product or business that is targeted for internal use and show

^{14/} Notice, paras. 86-89.

that their outside sales of those specific products exceed 50% of each one's total volume.

CONCLUSION

ICA believes that there will be a number of ways to ascertain fair market value of affiliate transactions,^{15/} and thus a determination by the Commission of acceptable valuation methods at this time would not increase the efficiency of the cost allocation rules. But full disclosure of the fair market valuation methods is crucial. Disclosure is enhanced, in turn, to the extent the carriers' reporting of valuation methods in the manuals is as uniform as possible. While absolute uniformity on the LECs' cost manuals continues to be an elusive goal, we believe that a much greater degree of uniformity can be achieved by requiring LECs to specify the USOA accounts affected by the fair market valuation methods they select with respect to specific affiliate transactions.^{16/} Thus, while a range of fair market valuation methods should be permitted by Commission, the impact of those methods on different carrier's USOA accounts should be testable by the Commission as well.

ICA supports each of the Commission's other proposals concerning the contents of cost allocation manuals, the role of

^{15/} Notice, paras. 90-92 and 97.

^{16/} This account designation on the regulated side would not alter the Commission's proposal that carriers fully subject to the rules would use GAAP with respect to nonregulated accounting unless directed otherwise by the Commission. Notice, para. 51.

independent auditors regarding affiliate transactions and specification of the audit trail.^{17/}

In conclusion, the International Communications Association respectfully requests that the Commission promptly adopt the modifications to the cost accounting rules proposed in the Notice consistent with ICA's comments herein.

Respectfully Submitted,

INTERNATIONAL COMMUNICATIONS ASSOCIATION

By 

Brian R. Moir, Esquire
1255 23rd Street, N.W.
Suite 800
Washington, DC 20037-1170
202/331-9852

Its Attorney

December 10, 1993

^{17/} Notice, paras. 93-99.

CERTIFICATE OF SERVICE

I, Laura K. Higgins, hereby certify that a true and correct copy of the foregoing "Comments of the International Communications Association" were hand delivered this 10th day of December, 1993, to the following:

William A. Kehoe, III
Federal Communications Commission
2000 L Street, N.W.
Washington, DC 20554

William A. Kehoe, III
Accounting & Audits Division
Federal Communications Commission
2000 L Street, N.W.
Washington, DC 20554


Kathleen Levitz, Acting Chief
Common Carrier Bureau
Federal Communications Commission
1919 M Street, N.W. - Room 500
Washington, DC 20554

Karen Brinkmann
Office of the Chairman
Federal Communications Commission
1919 M Street, N.W. - Room 814
Washington, DC 20554

Rudolph Baca
Office of Commissioner Quello
Federal Communications Commission
1919 M Street, N.W. - Room 802
Washington, DC 20554

Linda Oliver
Office of Commissioner Duggan
Federal Communications Commission
1919 M Street, N.W. - Room 832
Washington, DC 20554

Jeffrey Hoagg
Office of Commissioner Barrett
Federal Communications Commission
1919 M Street, N.W. - Room 844
Washington, DC 20554


Laura K. Higgins